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The Open University

# Equity Market and Accounting System in China

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## **Abstract**

Financial reporting practices have developed rapidly since the establishment of China's equity market in 1990. More decision-useful accounting information is required by the investors. An understanding and insight of how the development of equity market has influenced the accounting reform is important in facilitating international convergence of accounting standards and practices. This study investigates the influence of the equity market on accounting reform in China. In this study, I hypothesize that the requirement for the decision-usefulness of accounting information disclosure is the main motivation for the development of the CAS. I analyze the problems of accounting information derived from the immature equity market by identifying the three issues: (1) special ownership structures, (2) weak corporate governance mechanism of the listed companies, and (3) the segmentation of the equity market. Examples are given to present the unreliability of accounting information through accounting manipulation and even financial frauds, and the lack of understandability and comparability of accounting information across countries. Finally, I discuss the responses of accounting reform to the requirement for accounting information derived from equity market from two aspects: (1) narrowing the gaps of accounting practices between the CAS and the IAS and (2) regulations of and requirements for information disclosure.

**Abbreviations**

ASBE	Accounting standards for Business Enterprises
CAS	Chinese Accounting Standards
CIA	Central Intelligence Agency
CICPA	Chinese Institute of Certified Public Accountants
CSRC	China Securities Regulatory Commission
EAS	Enterprise Accounting System
FASB	Financial Accounting Standards Board
FASC	Statement of Financial Accounting Concepts
FIBV	World Federation of Exchanges
GDP	Gross Domestic Product
IAS	International Accounting Standard Committee
IASB	International Accounting Standard Board
IASC	International Accounting Standard Committee
IPO	Initial Public Offering
MoF	Ministry of Finance
ROE	Return on Equity
SFAC	Statement of Financial Accounting Concepts
SHSE	Shanghai Stock Exchange
SOE	State Owned Enterprises
SEC	Securities Exchange Committee
SZSE	Shanghai Stock Exchange

## **1. Aims and Objectives**

After decades of heavy government involvement in the economy, China has embraced a market-liberalization program. State intervention in enterprise management, particularly through SOEs, is being systematically dismantled. Prior research evidence indicates that over the last decade the modernization and restructuring of SOEs have been placed at the top of the economic-reform agenda.

The environment in which a country operates shapes its national accounting practices (Walton et al., 2003; P2). Hopwood (1987) discusses the interrelation between accounting changes and the social context, and points out that accounting is not static but changeable in response to interrelated changes in society. With the trends of economic modernization, the old accounting systems in china which was designed to serve the centrally controlled economy has dramatically changed (Tang, 2000). The need for China's accounting reform has been influenced by many factors (Zhang, 2005), including involvement of the Chinese government in macro-economic management, the increasing complexity of business transactions, diversified business ownership in a variety of industries, and the expansion of the securities market. Also, Chinese companies seeking to raise capital in the international capital markets are faced with the challenge of restating their financial statements to international standards. "Investors demand greater transparency and accountability. China moves to bring the accounts of listed companies closer to international standards" (Xue and Tian, 2000; p13).

In order to accommodate the rapidly changing economic environment, the accounting reform in China becomes an important aspect of the financial and economy reform.



International accounting practice was regarded as the basis for re-engineering the accounting system (Tang, 2000).

My study aims to look at the relationship between the Chinese accounting reform and the development of equity market in China. Although the environment of the Chinese accounting system have been discussed in several prior academic studies (e.g., Xiang, 1998; Xiao et al., 2004), especially the significant role of political ideology in shaping accounting system in China (Hilmy, 1999; Graham and Li, 1997; Zhang, 2005; Ezzamel et al, 2007), but few of them investigate the in-depth influence of equity market on accounting system. Although the market is young with a history of only 18 years, it developed very rapidly and made strong demands on accounting reform and convergence towards the IAS. This study pointed out the unique issues and problems in the development of equity market in a transition economy, such as state-owned listed companies, weak corporate governance mechanism, and the segmentation of the equity market. These problems lead to the lack of decision-useful accounting information. This study provides insight into how the problems were made efforts to solve in accounting system reform in China. Such insights may facilitate understandings of the challenges in achieving international accounting harmonization in China.

The remainder of this paper is as follows. The next section provides the background to the study and the theoretical framework. The methods of data collection are described in Section 3. Section 4 describes data analysis. Section 5 contains data interpretation. Finally, Section 5 concludes the paper.

## **2. Literature Review**

### **2.1 Theoretical Framework**

My research is built upon Nobes' model (Nobes, 1998) for classification of differences of financial reporting and Ball's argument regarding demands for accounting information.

Nobes' (1998) model is relevant to an examination of why different countries use different financial reporting systems. The model proposes that culture influences the financing system in a country, which in turn influences the accounting system. He divides the financing systems into two types: strong credit-based system and strong equity-based system. This division was developed and related to source of finance.

Nobes emphasizes that differences in source of finance lead to differences in the purpose of accounting and determine which type of accounting a country uses. He classified accounting practices as "strong equity reporting" and "weak equity reporting", which are also respectively referred to generally as "shareholder model" for market-oriented common-law countries and "stakeholder model" for code-law countries (Nobes and Parker ,2005). Two classes of accounting, Class A and Class B, are proposed by Nobes (1998). Class A accounting occurs where there is a strong equity market and accounting provides information for outside shareholders. These countries mainly include UK, the US and Australia. Class B corresponds with credit-oriented financing and focus on accounting for creditors and tax purpose, and examples of Class B countries are France, Germany and Italy.

Nobes (1998) takes the example of China as ‘a country without a strong equity-outsider tradition, but which seems to be moving towards such a system’ ((p. 169). The ratio of market capitalization to GDP used to measure the relative importance of the equity market in various countries (Nobes and Parker, 2005). We consider the countries sampled by Jaggi and Low (2000)—Australia, USA, the UK, Germany, and Japan—and add a number of Eastern European countries which resemble China in moving from central planning to a market-based economy.

**Table 1 Relative Importance of Equity Market**

(USD millions)

country	Domestic market capitalization <sup>1</sup>	GDP <sup>2</sup>	Market capitalization to GDP	Strength of equity market
Australia	1095858.0	666300	1.64	Strong
U.K.	3794310.3	1903000	2.00	Strong
U.S.A	19286171.5	12980000	1.49	Strong
Japan	4909937.8	4220000	1.16	Strong
Germany	1637609.8	2585000	0.63	Weak and strengthening
Poland	151809.0	542600	0.28	Weak
Romania	172372.2	556100	0.31	weak
China	1145454.8	10000000	0.11	Weak

<sup>1</sup> FIBV annual report (2006)  
<sup>2</sup> CIA World Factbook (2006)

From Table 1, we could easily find out that the equity market in China is small-scale and remains quite unimportant compared to the strong equity-outsider countries and other traditional weak equity-outsider countries.

Ball et al. (2003) argue that financial reporting quality is an endogenous function of market demands and political influences that are specific to each country. They point out that shareholder-oriented reporting typically gives exclusive corporate governance rights to shareholders, and information asymmetry is more efficiently resolved through public disclosure. The demand for high quality financial reporting and disclosure is enforced in a system that is primarily market-based. In code-law countries, characterized as stakeholder-oriented reporting, standards setting and enforcement are primarily public-sector functions, and information asymmetry is more likely to be resolved by “insider” communication with stakeholder representatives. Therefore, there is lower demand for high quality public financial reporting and disclosure.

The primary objective of accounting is to satisfy the information needs of financial statement beneficiaries (FASB, 1978, SFAC No.1). The demands of financial statement users and other interested parties are a driving force for the development of accounting standards and practices.

## **2.2 Historical Development of Accounting System**

Prior to 1978, China's economy was dominated by SOEs which were essentially production units to fulfill the states stipulated production quota. The accounting system at that time was primarily macro-oriented in that it assisted the state in economic planning, implementing state economic policies, and controlling the means of production (Ge and Lin, 1993; Ezzamel et al., 2007). The accounting standards used by commercial and industrial enterprises were rigid and uniform. There are also uniform

budgetary accounting for government agencies and non-profit organizations (Aiken and Lu, 1998).

After the open-door policy started in 1978, gradual change in ownership structure caused the importance of the state-owned dominance to decrease and non state-owned enterprises to increase. In response to the increasing opportunities of foreign direct investment, China's accounting reform commenced in 1985 with the establishment of *the Accounting Regulations for Joint Ventures using Chinese and Foreign Investment*. These regulations provided basic accounting guidelines for joint ventures operating in China and for attracting further foreign investment thereafter (Xiang, 1998). From an accounting perspective, these regulations for the first time introduced Western accounting practice, which was a radical deviation from the traditional accounting (Chow et al., 1995).

State enterprises, once the production units in the centrally planned economy, are now endowed with a substantial degree of managerial autonomy and a separation of management from ownership (Xiang, 1998). In response to these changes and the opening of the stock markets in 1990, a new accounting regime, summarized in Table 2, is emerging.

**Table 2 the Chinese Accounting Regime: Regulators, Regulations and Applicable Enterprises**

Regulator	Regulation	Applicable enterprise
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The National People's Congress	The Accounting Law (1985, revised in 1993, 1999)	All enterprises
	The Audit Law (1994)	SOEs
	The Law on Certified Public Accountants (1993)	Auditing profession
	The Company Law (1993)	Share capital-based companies
	The Law for State-owned Industrial Enterprises (1988)	SOEs
	Byelaw of Enterprises' Financial Accounting Reports (2000)	All enterprises
The State council	Tentative Regulations on the Management of the Issuing and Trading of Securities (1993)	Share capital-based companies
	Provisional Byelaw of Stock Issuance and Exchange(1993)	Public issuing companies
	Enterprise Financial Reporting Regulation (1999)	Public issuing companies
Ministry of Finance	the Accounting Regulations for Joint Ventures Using Chinese and Foreign Investment (1985)	Joint ventures
	Accounting Regulations for Experimental Listed Companies (1992)	Public issuing enterprises
	Accounting Standards for Business Enterprises (1993)	All enterprises
	Independent Auditing Standards ( 1995)	All enterprises

China Securities Regulatory Commission	Accounting Regulations for Listed Companies (1998)	Public issuing companies
	Enterprise Accounting System (2000)	All enterprises
	Provisional Regulations on Accounting Treatments of Assets Sale Among Related Parties (2001)	Public issuing companies
	Accounting Standards for Business Enterprises (2006)	All enterprises
	Implementing Rules on Information Disclosure by Public Issuing Companies (Trial) (1993)	Public issuing companies
	Standards of Contents and Formats of Information Disclosure by Public Issuing Companies (revised in 1994, 1997, 1998, 1999, 2001, 2003)	Public issuing companies
	Answers to the Information Disclosure Regulations of Public Issuing Companies (2001)	Public issuing companies
	Regulation for Corporate Governance in listed Companies (2002)	Public issuing companies
	Preparing Rules of Information Disclosure by Public Issuing Companies issued (2002)	Public issuing companies
	Regulations on Information Disclosure of Listed Companies ( 2006)	Public issuing companies

Data source: Xiao (1999); CSRC (2006).

From Table 2, it can be seen that National People's Congress which represents the ultimate power of legislation stipulated a number of basic laws. Under the People's Congress, the State Council has also promulgated regulations on a number of important issues. Meanwhile, two main bodies have been established by the State Council to be responsible for accounting and reporting affairs. One is the MoF which was empowered to manage accounting affairs. It issued basic accounting standards and a conceptual framework to underpin specific standards. The other body is the CSRC, established by the State Council in response to the development of the equity market and regulation of financial reporting (Xiao, 1999).

The accounting reform can be roughly divided into three periods after the establishment of equity market, according to the three sets of basic accounting standards issued in 1993, 2000 and 2006 separately.

China initiated its accounting reform in 1992 with the enactment of *Accounting Regulations for Experimental Listed Companies* by the MoF. It applied to all share capital-based companies, including the listed companies, and was enacted as a response to the corporatization drive of the SOEs. After the issuance, preparation of the balance sheet should list equities separately, and report the capital increment in income statement. The new regulation was the first set of rules to incorporate international accounting practices into reporting requirements for China's domestic enterprises (Xiang, 1998).



ASBE, China's first "accounting system", was issued and became effective in 1993 (Chen et al., 1999; Lin et al., 2001). It set up a conceptual framework and provided the guidelines for following the IAS for financial reporting. In addition, the government made efforts to develop a series of transaction-based "practical accounting standards" with the financial support of the World Bank and technical assistance from the Big Six international accounting firms (Hepp and Chen, 1997).

In 1998, the MoF issued *Accounting Regulations for Listed Companies*, replacing *Accounting Regulations for Experimental Listed Companies* in 1992 (MoF, 1998). With the important breakthrough of the socialist market economy in ownership system, the innovation of accounting system was promoted.

In 2000, with the issuance of revised version of the *Accounting Law of the People's Republic of China* and *Byelaw of Enterprises' Financial Accounting Reports*, a new *Enterprise Accounting System* was promulgated to improve the groundwork for China to be consistent with the IAS.

In February 2006, the MoF issued of the long-awaited new ASBE which consist of a new Basic Standard and 38 Specific ASBEs (Deloitte, 2006). It was influenced by the IAS, and some significant changes were introduced, of which the most important shift was the introduction of fair value. Therefore, the new Chinese set of accounting standards issued in 2006 by the MoF, is usually considered, at least to a large extent,

as the ultimate convergence of the Chinese system with the IAS (Biondi and Zhang, 2007).

### **2.3 Requirements for Information Disclosure in China**

Ma (1998) and Qi et al. (2000) identify the close relationship between SOEs and the equity market. The establishment of the equity market in the early 1990s is due to the systematic ownership reform of the SOEs, which was thought to be able to largely enhance the performances of SOEs (Qi et al., 2000). SOEs remained uninvolved in these markets until 1994, when 100 SOEs were selected by the state to be “corporatized”. While unprofitable small- and medium-sized SOEs were privatized or merged, large SOEs were converted into shareholding companies with limited liabilities, and a selected few were listed on China’s two stock exchanges (Yuan, 2000). Nowadays, a majority of Chinese stock companies were restructured from the former State-owned enterprises.

The traditional accounting information in China was only used to serve the needs of the government and managers of enterprises. Since these two users were the same in nature in the context of the contemporary China, it was by no means necessary to disclose the accounting information (Chen et al., 2005; Ezzamel et al., 2007). However, based on Ball et al. (2003), with the development of the equity market, the demands on accounting information from public investors were gradually stronger.

Financial information disclosure of the listed companies has been required since the establishment of the SHSE and the SZSE in 1990. The earliest information disclosures included mainly the financial status of the companies (in equivalence to a simplified balance sheet and the statement of profit and loss), forecasts for the profitability, and distributions of dividends (Xue and Tian, 2000). The purpose of the requirements of accounting information disclosure is to provide investors with sufficient, reliable and comparable information such as business operations and financial position about a targeted listing company on time, so as to help the decision-making of investors (CSRC, 2006).

An equity market regulatory and supervisory body – the CSRC– was established in 1992 to establish a centralized supervisory system and strengthen the supervision over securities markets. In addition, to raise the standard of information disclosure and organize the drafting of laws and regulations for equity markets are the functions of the CSRC as well (Xue and Tian, 2000). The CSRC is responsible for reviewing and censoring all sorts of reports concerning information disclosure. It determines and approves whether companies are qualified for listing and remaining as listed (CSRC, 2006). As a result, it is an obligation for these companies to submit and present accounting information contained in their reports with a manner of accuracy, integrity, and authenticity (Chen et al., 2005).

In China, listed (A-, B-shares and foreign listed shares such as H-shares<sup>1</sup>) companies are requested to disclose accounting information and must follow both the Basic Standards (for example, the ASBE issued in 1993, the EAS issued in 2000 and the new ASBE issued in 2006) and *the Accounting Regulations for Listed Companies*. These two sets of regulations together govern the requirements for preparing financial statements for listed companies and mainly deal with accounting assumptions, accounting principles, accounting elements, recognition, measurement and financial statement issues, etc. Listed companies are also subject to the regulations released by the CSRC.

Apart from preparing financial statements based on the Basic Standards and *the Accounting Regulations for Listed Companies*, B-shares issuing companies have to provide summarized financial statements in terms of the IAS. Companies issuing H-shares must conform to the disclosure requirements for listing on the Hong Kong Stock

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<sup>1</sup> A-shares are issued by companies incorporated in mainland China and are traded in the mainland A-share markets (SHSE and SZSE). The prices of A-shares are quoted in RMB, and currently only mainlanders and selected foreign institutional investors are allowed to trade A-shares.

B-shares are issued by companies incorporated in mainland China and are traded in the mainland B-share markets (SHSE and SZSE). B shares are quoted in foreign currencies. In the past, only foreigners were allowed to trade B shares. Starting from March 2001, mainlanders can trade B shares as well. However, they must trade with legal foreign currency accounts.

H- shares are issued by companies incorporated in mainland China and are listed on the Hong Kong Stock Exchange and other foreign stock exchanges.

Exchange, which has stricter information disclosure requirements than those of A- or B-shares (CSRC, 2006).

Furthermore, the Chinese accounting standards based financial statements must be audited by independent accountants, who normally are from Chinese accounting firms that are qualified by the CSRC. The IAS based financial statements for B-share companies, on the other hand, should be audited by the Big Six (Arthur Andersen, KPMG, Ernst & Young, Deloitte & Touche, Coopers & Lybrand, and Price Waterhouse) accounting firms and other international firms (CSRC, 1994).

## **2.4 Hypothesis and Research Questions**

Based on Nobes (1998; 2005) and Ball et al. (2003), together with the overview of the accounting reform and the development of equity market in China, I developed the following hypothesis for my study:

Hypothesis 1: The requirement for the decision-usefulness of accounting information disclosure is the main motivation for the development of Chinese accounting system towards a class A accounting system.

In general, the usefulness of an accounting system depends upon whether it generates accounting information that satisfies the decision needs of its users (Holthausen and Leftwich, 1983). As stated in the SFAC No. 1, issued by the FASB, decision usefulness is the primary objective of financial accounting (FASB, 1978). Usefulness of information

includes several qualitative characteristics such as reliability, understandability, comparability and so forth (FASB 1980, SFAC no. 2).

Over the last three decades, SOEs lost their shares in the national economy while non-state-owned economy consisting of foreign affiliated entities and private businesses grew rapidly. Non-government users of accounting information emerged in the course of economic diversification. Following the deregulation of government business administration, some SOEs have been listed, and business management has been increasingly exposed to market pressures. In the changing business environment, accounting information is required not only by state economic plans and business administration at the macro level but also by external investors, creditors, business management, and foreign investors for a great variety of decision-making needs. Thus, the new accounting system has expanded changes in the content and format of the financial statements to satisfy the requirement for the decision-usefulness of accounting information (Ge and Liu, 1995; Chen et al., 2005).

The improvement of accounting information relies on the development of accounting system reform (Lin et al., 2001). In my research, the efforts of accounting system reform to improve the decision-usefulness of accounting information disclosure are divided into two types: accounting standards in convergence towards the IAS, and regulations and requirements for information disclosure of listed companies.

The hypothesis mainly focuses on the requirement of accounting information for accounting system reform. My research purpose is to investigate the influence of equity

market on accounting reform. To address the related issues, I developed three specific research questions:

Q1. How does the weak equity-outsider market lead to the lack of decision-usefulness of accounting information?

Q2: How do the problems of accounting information reflect in financial reporting of Chinese listed companies?

Q3: How does the accounting reform respond to the requirements for decision-usefulness of accounting information?

### **3. Methods of Data Collection**

This study investigated these questions via a combination of archival data and interviews. A combination of these two methods enables us to (1) highlight the facts in China's accounting system reform; (2) explain the facts, and answer research questions. In the study, archival data are used to describe the facts about the development of the equity market and accounting reform. Archival data are typically large and often national samples, as a result, can perform newer and more powerful statistics. They are used as pilot data for exploratory study (Shultz et al., 2001). However, archival data research can suffer from several disadvantages related to variable specifications and the inability to ask qualitative questions (Graham et al., 2005). These problems could be compensated by the method of interviews. Interviews provide good opportunities to ask people from various interest groups specific questions about the reasons of problems derived from equity market and evaluations for the evolutions of accounting standards.

In addition, Interviews are “most useful for evaluating programs that are seen as dynamic or evolving” (Patton, 1987). On the other side, the combination of the two methods cross-checks data from different sources to give a more detailed and balanced picture of the situation.

The archival data used in the study fall into four categories. The first category consists of accounting regulations and rules issued by the Chinese government and the regulatory body. The second category consists of secondary academic literature by both Western and Chinese scholars. The third consists of economic and accounting data regarding the Chinese equity markets and listed companies. A major source of this data is the websites of the stock exchange themselves, which contain archival records of market filings and transactions. The fourth category is information from Chinese news media covering the equity markets and related economic events.

Semi-structured interviews were carried out as supplements of the archival data. Due to the tight time schedule and the attribute of the research as a pilot study for my PhD dissertation, I have focused on 6 individuals who are identified as closely involved in the accounting regulation and accounting practices in the listed companies and equity market. The interviewees are from various interest groups, including one accounting regulator, two accounting academics, one security market analyst, and two financial managers in listed SOEs (see Table 3).



5 out of the 6 interviews were conducted via telephone, and the only one that was carried out face-to-face in London was with the regulator who was introduced by my supervisor. Both the academics are from Chinese universities with most prominent accounting education. One of them was introduced by my former supervisor. I met the other academic and the security market analyst in a seminar concerning Chinese capital market environment two years ago and have kept contact since then. The two financial managers were introduced by a government official I am familiar with. Both of them have worked for large-scale SOEs for over 10 years and taken part in the restructure process of this enterprise in mid 1990s.

To preserve anonymity, we designate interviewees as A, B, C, etc. and provide their background information in Table 3. The transcripts of interviews conducted in Chinese were translated into English by the author.

**Table 3   background of interviewees**

<b>interviewee</b>	<b>Company</b>	<b>Experience</b>	<b>Date of interview</b>
Interviewee A	A regulatory body	Involved in accounting regulation from 1997 to date	06.2008
Interviewee B	University 1	Leading accounting academic in China. Involved in accounting regulation from 1992 to date	04.2008
Interviewee C	University 2	Leading accounting academic in China. Involved in accounting regulation from 1998 to date	07.2008
Interviewee D	A leading domestic security company	Senior equity market analyst. Being an analyst for over 10 years with expertise in	04.2008

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		financial frauds and information disclosure	
Interviewee E	Listed state-owned enterprise 1 (Shanghai)	Financial director. Has worked for the company for over 15 years as Internal auditor and financial manager. Experienced the SOEs restructuring and IPO in 1995	04.2008
Interviewee F	Listed state-owned enterprise 2 (Shenzhen)	Financial manager with experiences in financial practices of SOEs for over 10 years	05.2008

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Five interviews were conducted in Chinese, and one in a mixture of English and Chinese. All interviews were tape-recorded and transcribed. Each interview lasted around one hour, except for the face to face interview which lasted for one hour and a half. A list of interview questions was prepared by the author, based on the research questions and the theoretical framing, modified in light of findings from earlier interviews. The issues covered included<sup>2</sup>:

- Major changes in accounting regulation since the establishment of the equity market in 1990; contexts of and reasons for change.
- The groups or key individuals involved in these changes.
- Reasons for, and processes of, setting accounting standards.
- The problems and improvement of decision-usefulness of accounting information.

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<sup>2</sup> Full text of the interview questions is listed in Appendix.

For the ethical considerations, there were no obvious disadvantages or offences to the benefits of the interviewees based on the contents of interviews, except some accounting manipulation problems in listed companies.

To minimize the influence of ethical issues on the research, I stress anonymity and assurances of confidentiality and try to persuade the respondent of privacy and the avoidance of harassment. The interviewees were fully informed of all the relevant details of the research, with an opportunity to refuse to participate. Honest identification of my research goal was provided to them, and the promise that the research will report to no one but the research organization was made. In addition, the respondents were informed of the employment of tape-recorder to minimize misrepresentation.

#### **4. Collecting and Analyzing the Data**

The methods of daily interactive analysis and framework analysis were used in the process of data collection and analysis. The objective of daily interactive analysis is to assemble and interpret the information that was collected. Observational notes were written down at the end of every day of interviewing based on the information provided and related to the main objectives of the study, and initial conclusions/concerns were then put down. The daily interactive analysis is important because, as time passes, data recorded on tape and in hand written notes becomes increasingly difficult to reconstruct information.

After all the interviews were done, framework analysis (Ritchie and Spencer, 1994) was carried out in four stages.

The first stage is to get myself familiar with the data. I listen up to tapes, reading the transcripts several times and reading the observational notes taken during interviews and summary notes written immediately after the interview.

The next stage involves identifying a thematic framework by writing short phrases, ideas or concepts arising from the texts in the margin of the text, and begins to develop categories. The data were divided into the following types: the characteristics of the Chinese equity market, the situation of accounting information, and the accounting reform in improving the decision-usefulness of accounting information. At this stage descriptive statements are formed and an analysis was carried out on the data under the questioning route.

The third stage is to manage the data. This stage includes indexing, highlighting and sorting out quotes. Charting, involves lifting the quotes from their original context and re-arranging them under the newly-developed appropriate thematic content. Computer-based approach to sort out and arrange data, read each quote and find out the relevant quote.

The last stage is mapping and interpretation. One of the tasks here is not only to make sense of the individual quotes, but also to see the relationship between the quotes and the data as a whole.

## 5. Interpreting the Data

### 5.1 Reasons behind the Problems of Accounting Information Disclosure in China

After the founding of the People's Republic in 1949, public ownership enterprises and a highly-centralized planned economy dominated until share-holding companies reappeared in China in the mid 1980s (Karmel, 1996). In October 1990, Shanghai Stock Exchange was opened in Shanghai, followed by the Shenzhen Stock Exchange in 1991, to allow public listing and trading of stocks and other securities in China (Ge & Lin, 1993; Chen et al., 1999). The two stock exchanges have expanded dramatically since then in line with the rapid growth of the Chinese economy. In December 2007, 857 companies were listed on the SHSE, with a trading volume of RMB 2959.5 billion in December (SHSE, 2007) (USD 1 =RMB 7.30); 729 companies were listed on the SZSE, with a trading volume of RMB 673.0 billion in June 2008 (SZSE, 2008) (USD 1 =RMB 6.85<sup>3</sup>). The Chinese equity market is now one of the most rapidly growing capital markets in the world (CSRC, 2006). Interviewee A remarked:

The rapidly-growing equity market both motivates, and provides a greenhouse for, experimenting with accounting standards, since accounting standards developed in China were mainly applicable to listed companies.

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<sup>3</sup> The exchange rate comes from the website of the People's bank of China:  
<http://www.pbc.gov.cn/huobizhengce/huobizhengcegongju/huilvzhengce/renminbihuilvjaoyis houpanjia.asp?page=8&col=&fromyear=&frommonth=&fromday=&toyear=&tomonth=&today=>

However, as previously described, the equity market in China is still a weak equity-outsider market, the reasons for which are special ownership structures, weak corporate governance mechanisms in listed companies, and the segmentation of the equity market.

### **5.1.1 Special Ownership Structure**

The political influence is determined by Chinese political ideology, and remains strong through the economic reform, especially the SOEs reform process. In addition, the establishment of the equity market was also closely related to the SOEs reform and therefore was inextricably intertwined with the government activities (Interviewee C).

As distinct from listed companies in the advanced economies, the majority of the listed companies in Chinese equity market started off as SOEs. Some of them were re-organized and restructured using certain assets carved out<sup>4</sup> from SOEs (Qi et al., 2000; Ding and Graham, 2007). The offering of shares in the open market has attracted a large number of individual and institutional investors. The listed SOEs are mandated to have three categories of ownership shares: state-owned shares held by the state, which are prohibited from trading publicly; institutional shares (also called legal person shares) owned by separate legal entities, such as investment institutions and the foreign partners of a corporatized joint venture. These shares also cannot be traded on the two

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<sup>4</sup> In forming a listed company, promoters would normally "carve out" all or a portion of its operating assets (e.g. a factory, a workshop or even a production line) and contribute this into the listed company. Assets not attributable to operations and/or other remaining assets are generally left behind. Consequently, the promoters and the listed company still maintain on-going business relationships, for example, up-stream and down-stream in the supply and demand chain. As a result, significant related party transactions exist.

exchanges, though they can be sold to other legal entities by agreement and upon approval by the government, and publicly-held shares which represent shares held by either institutional or individual investors (Jingu, 2002; Ding et al., 2007). At the end of 2006, the total outstanding shares of listed Chinese firms included 46.2% of state-owned shares, 17.5% of legal entity shares, and 34.8% of shares held by private investors (CSRC, 2006). As over 65% of company shares are not publicly tradable on the secondary market, their holders care less about share price changes and need relatively less information for investment decision-making compared with private shareholders. Moreover, these shareholders usually have access to inside information, which further reduces the reliance on external accounting information disclosure.

Due to the special ownership structure of listed companies, investors, creditors, and other relevant parties outside the enterprises, and management are all identified as the users of financial information in the basic accounting standards (EAS, 2000). This is an obvious difference compared with the framework of FASB which clearly states that the objectives of financial reporting are present and potential investors and creditors and other users in making rational investment, credit, and similar decisions (FASB 1978, SFAC No.1). Accounting interviewee A remarked:

Clearly, the requirements for financial information in an accounting system that satisfied all groups must be significantly different from a system that focuses on outside investors. We can not simply adopt many accounting concepts and principles developed in other countries to satisfy government and enterprise managers equally well.

Liu (2000), then Deputy Director of Department of Accounting Affairs Management of the MoF, acknowledges that accounting regulators in China 'have given significant consideration to the accounting information requirements of the government although also taking account of the information needs of the public and other users'.

### **5.1.2 Weak Corporate Governance Mechanisms**

As previously shown, the main differences between Chinese listed companies and listed enterprises in other countries are the state retaining a large investment. Many SOEs were reformed into limited liability companies with share capital and charters or articles of association. The boards of directors have similar structures and responsibilities as those in capitalist societies. However, the appointment of top management and directors is different from the U.S. and other developed countries. In the early years, the state, its ministries, and local government appointed the directors, or had veto power over the appointment. In recent years, the state's role in appointing top managers and directors has diminished (Chen et al., 2006).

However, the corporate governance of listed companies remained unregulated until the first *Regulation for Corporate Governance in listed Companies* was issued by the CSRC in 2002 (Zhu et al., 2004). Therefore, internal corporate governance mechanisms are weak or even non-existent in the listed companies. Denis and McConnell (2003) argue that ownership structure is the foundation of internal corporate governance mechanism.



Corresponding to different ownership structure, corporations should design a different system to balance shareholders' meeting, board of directors, supervisors and managers, in order to timely disclose corporate information, efficiently supervise managers and protect the interests of shareholders (Denis and McConnell, 2003). The corporate governance in China was described by Interviewee B as follows:

From the perspective of protecting the interests of minority shareholders, the controlling shareholders have great impact on the corporate governance improvement. The ownership concentration in China's listed companies makes the controlling shareholders almost dominate entirely the board of directors and the board of supervisors, which induces the imbalance of corporate governance.

Due to the irrational corporate governance mechanism, accounting manipulation and problems of listed companies' accounting information disclosure are extensive because controlling shareholders are much easier to mask true firm performance and conceal their private control benefits from outside investors (Liu and Lu, 2002; 2005; Chen et al., 2007).

There is also a high level of market speculation and manipulation in the market. The lack of transparent and reliable accounting information makes following the market price be the major investment strategy of most Chinese shareholders, resulting in high market speculation (Xiao et al., 2004). Private investors have a very short time horizon of

shareholding of less than one month on average in 2007<sup>5</sup>. In addition, although a number of financial institutions were sanctioned by the CSRC; large scale market manipulation by investment funds and securities companies is still extensive (CSRC, 2006). As a result of speculation and market manipulation, market prices are highly volatile, which in turn further reduces the value of accounting information.

### **5.1.3 Segmentation of the Equity Market**

Another important feature is the segmentation of Chinese equity market. Dual-class publicly-traded shares exists in listed companies: A-shares listed on either the SHSE or the SZSE are restricted to mainland Chinese investors; B-shares are issued to and traded exclusively among overseas investors (Lin et al., 2005; Groenewold et al., 2003; Chen et al., 2002). Although all classes of shares of one listed company are entitled to the same future cash flows, the market prices and performance of them are not closely related (Müller, 2007). A-share companies are required to present their financial statements in line with CAS<sup>6</sup>, whereas the B-share reports should be restated according to the IAS. Due to the gaps between the CAS and the IAS, there remain substantial discrepancies between accounting earnings computed under the CAS and the IAS (Chen et al., 2002) and reduce the comparability of the accounting information.

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<sup>5</sup> Data source: SINA finance (<http://finance.sina.com.cn>) (in chinese).

<sup>6</sup> In this study, CAS refers to all the standards and regulations issued by the MoF and the CSRC, including the 1993 ASBE, 2000 EAS and the 2006 new ASBE and other regulations and rules.

Although the equity market has played an important role in accounting standard setting in China, its continued structural weaknesses and significant imperfections have seriously negatively impact the reliability and comparability of accounting information and IAS-type accounting standards (interviewee E).

## **5.2 Existing Problems of Accounting Information Disclosure**

### **5.2.1 Unreliability of Accounting Information**

Financial reporting and information disclosure in Chinese equity market is underdeveloped compared with the standards in strong equity-outsider countries. A major problem exists in the lack of transparent and reliable accounting information to help investors effectively make decisions (Chan and Rotenberg, 1999; Tang, 2000). Accounting interviewee A and D pointed out that:

The 1993 ASBE provided some ambiguous requirements for information disclosure, and standards for accounting practices left large space for accounting manipulation. Moreover, legal and institutional framework of the securities markets is still relatively primitive. Concerns have been raised on the quality of accounting and reporting practices in China, due to the increasing exposures of accounting scandals in the listed companies in middle to late 1990s.

#### **5.2.1.1 Financial Fraud due to Accounting Manipulation**

Generally-used methods of financial fraud were summarized by interviewee D and F:

Common types of fraud perpetrated by firms and their managers include inflating profit numbers, creating fictitious transactions, and false disclosures.

The following two examples briefly detail equity market scandals that were investigated by the CSRC<sup>7</sup>.

### **Zheng Baiwen: Falsified Sales Revenues and Profits**

In 1997, Zheng Baiwen (600898, SHSE) reported a net profit of RMB812.9 million and a return on capital of 20.7%. It was among the largest 100 listed companies in China. In 1998, the profits collapsed into large losses and the stock price fell dramatically. The CSRC stepped in to investigate the firm and found that sales revenues and profits had been falsified since 1995 and the information published in the IPO prospectus was a sham.

### **Vitality 28: Lack of Disclosure**

Listed in May 1996, Vitality 28 (600703, SHSE) controlled two-thirds of the laundry detergent market in China. Although the Company had repeatedly denied that it was

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<sup>7</sup> The source of these two examples is SINA finance (<http://finance.sina.com.cn>).

engaged in any joint ventures before its listing, the Company suddenly set up a joint venture with the German company Benckiser only 10 days after listing. The deal gave the German company 50 years' right to use its registered brand name. The company had failed to disclose this important information in its listing documents. The CSRC also found that the Company reported a total of RMB227.92 million in fictitious profit: RMB16.68 million on its documents for listing application and a total RMB211.24 million from 1996 to 1998. In addition, the Company did not disclose a RMB130 million debt owed by its unlisted parent company Vitality 28 Group. This was only one example of numbers of important related party transactions which were not disclosed by the company.

The audit quality which originates from the lack of audit independence also contributes to the accounting information crisis in the late 1990s. Although the Audit Law was issued in 1994 and audit reform is underway, the independent status of CPA profession in China has not yet established (Tang, 2000; Xiao et al., 2000). Firstly, the involvement of the government agencies in the audit profession served as a shield for the accountants who did cannot bear full responsibility and the legal liabilities (Yang et al., 2003). Secondly, the CICPA is directly supervised by the MoF. This subordination severely affects the independence of the audit profession (Tang, 2000). Thirdly, government-affiliated audit firms were still the dominant group in the audit market (Yang et al., 2003). Thus, the widespread government ownership of both clients and their auditors gives rise to potential conflicts of interest in audit practice and finally impact the audit quality.

### **5.2.1.2 Major Means to Accounting Manipulation: Related Party Transaction as an Example**

China's listed companies tend to manipulate earnings for the purpose of obtaining the rights to issue new equity after an IPO and avoiding de-listing (Liu and Lu, 2002).

In 1996 the CSRC regulated that the annual ROE must be no less than 10% for China's listed companies to issue additional shares. In 1999, the CSRC revised the qualification for issuing additional equity, requiring that a listed company has to maintain a minimal ROE of 6% for recent three years, and the average ROE over these three years must be no less than 10% (CSRC, 1999). Because a listed company's application for permission to issue new shares is conditional on the ROE, listed firms have strong incentives to manage earnings above those thresholds. In fact, a disproportionately high number of companies were found to report ROEs just slightly over 6% and 10% in recent years (Liu and Lu, 2007). Some methods generally used by listed companies to manipulate profit were identified: through increasing investment income; through non-operational activities; through enlarging credit sales or recognizing revenue in advance; through transactions with related parties (interviewee D and F).

Among these methods, interviewee D and F thought that the transactions with related parties are prevalent in China's listed companies due to its diversity of forms and China's special ownership structure. Table 4 shows that the proportion of companies with related party transactions is quite high.

**Table 4 Data of Related Party Transactions in China's Listed Companies**

Year	1998	1999	2000	2001	2002
The number of listed companies	851	949	1088	1160	1224
Number of listed companies in which related party transaction took place	678	420	983	949	710
%	79.7%	44.3%	90.4%	81.8%	58.0%

Data sources: Fan Gu, Linqi Lan, "Shanghai Security Weekly", October 2003 (in Chinese)

The purpose of related party transactions is costs saving and tax shield (Zhong, 2005). However, as Table 5 shows, among the 606 companies that disclosed related party transactions, the proportion of related purchase and sale in related party transactions in China's listed companies was quite low, only accounting for 12.7% and 13.5% of all forms of related party transactions. Most of the related party transactions were equity investment, assets disposal and share disposal, the total amount of which accounts for an unusual 80% of all forms of related party transactions. Thus, it is possible that the listed companies had planned most of the transactions purposely. Interviewee F explained:

...At the end of one fiscal year, due to increasing operational pressure, we planned more related party transactions to manipulate profit in order to enhance performance purposely and cater to the market expectation. As far as I know, it is

very common for listed companies to arrive at predetermined profit target through related party transactions...

Table 5 Forms of Related Party Transactions in 2002  
(RMB millions)

Forms of related party transactions	Amount	%	Number of transactions	%	Number of corporations	%
Raw material purchase and service receiving	26351.3	16.4	118	8.5	77	12.7
Raw material sales and service providing	25581.5	16.0	140	10.1	82	13.5
Assets disposal	17614.0	11.0	155	11.2	124	20.5
Assets purchase	28810.4	18.0	32	2.31	25	4.1
Equity investment	30034.5	18.7	407	29.4	267	44.1
Equity shares disposal	3864.3	2.4	122	8.8	92	15.2
Assets replacement	12035.7	7.5	96	6.9	83	13.7
Surety	6319.3	3.9	53	3.8	36	5.9
Lease	5765.6	3.6	74	5.3	60	9.9
Trust operation	2315.0	1.4	37	2.7	33	5.5
Total	160295	100	1385	100	606	100

Data source: Huang, B. (2003) , 'Research on Supervision Problems in Related Party Transaction in Chinese Listed Companies', Shenzhen Zhongyan (in Chinese)

The disclosure problems of related party transactions in China's listed companies can be classified as three categories: insufficient disclosure or no disclosure, untimely disclosure, and false disclosure.



First, listed companies do not disclose the related party transaction sufficiently or do not disclose at all. As the interim report of 1997 showed, though 116 listed companies disclosed related purchase and selling transactions, only 27 companies only showed the existence of the transactions. Companies disclosing the detailed price of each transaction were 67, accounting for only 57.8% of all 116 companies (SHSE, 2000).

Second, listed companies disclose related party transactions untimely. Due to the asymmetry of accounting information, related party transactions must be disclosed sufficiently and timely to current and potential shareholders. Otherwise, it can damage the interests of the stakeholders who had relatively less information. For example, Jiabao Industry (600622, SHSE) provided investment of RMB 16 million for its subsidiary Shanghai Jiabaoqi Real Estate Corporation in early 1998. All these transactions should have been disclosed in the interim report of 1998, however, Jiabao Industry did not disclose the transaction until the interim report of 1999 (SHSE, 2000).

Third, listed companies usually choose to disclose untrue information after manipulating profit through related party transactions, with the intention to meet certain ROE threshold to stay listed, to impact the stock market price, to evaluate the management achievement or to finance conveniently. For example, in December 1996 Qiong Minyuan (000508, SZSE, already de-listed) made up profit RMB 540 million through invalid contracts of building construction and equity disposal with related party<sup>8</sup>.

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<sup>8</sup> The example is from SINA finance (<http://finance.sina.com.cn>).

### **5.2.2 Incomparability of Accounting Information across Countries**

Although Chinese accounting regulatory body made efforts to converge towards the IAS, accounting information from financial reporting were quite different under the CAS and the IAS. Chen et al. (2002) empirically testifies that the earnings gap based on IAS and CAS is quite remarkable. Chen et al. (1999) document significant differences between the 1993 the ASBE and the IAS. They compared the CAS with the IAS for twelve factors that are responsible for the differences in reported accounting earnings under these two alternative sets of accounting rules. Differences regarding required accounting were identified to contribute a lot to differences in financial reporting under the CAS and the IAS (Chen et al., 1999). Interviewee A remarked:

The poorly developed capital market in China has also placed many constraints on the adoption of accounting methods. For example, the 2000 Enterprise Accounting System had to suspend the adoption of the fair value approach to valuation of assets, which was previously stipulated in an accounting standard, because it is impossible to obtain a fair value for many assets in the Chinese capital market. This indicates that an immature capital market provides a poor context within which accounting standards may evolve and develop.

#### **5.2.2.1 The Choice of Fair Value and Historical Cost Approach**

The choice between fair value and historical cost approach for evaluation is an important difference of accounting practices between the IAS and the CAS. Historical cost method was always used in China's traditional accounting system and was also introduced into the 1993 ASBE. It has its own advantages and disadvantages, just as Interviewee B summarized:

Historical cost has its merits of objectivity, applicability, and verifiability. However, it failed to reflect current dynamic economic reality in many cases. Therefore, various modifications have been adopted in practice. A mixture of historical cost and current value becomes common and is recognized by accounting standards-setting bodies in many countries.

Historical cost approach was strictly adhered to by China's 1993 ASBE, and any deviation to historical cost was prohibited. To illustrate:

The values of all assets should be recorded at historical costs at the time of acquisition. The amount recorded in books of account should not be adjusted even though a fluctuation in their value may occur, except when State laws or regulations require specific treatment or adjustments. (Article 19)

Marketable securities should be accounted for according to historical cost as obtained. Marketable securities should be shown in book balance in accounting statement. (Article 26)

All inventories shall be accounted for at historical cost as obtained....All the inventories shall be disclosed at historical cost in accounting statement. (Article 28) (ASBE, 1993)

The choice between historical cost and fair value was determined by reliability and relevance of accounting information (interviewee B). The application of fair value by the IAS reflects that dynamic economic environment where timely and forward-looking information is crucial, and the decision making depends more on the relevance of accounting information than on the reliability (Tang, 2000). Interviewee B explained the reason for Chinese chose to use the historical cost method:

You can attribute it to the SOEs restructuring. With the transform from SOEs to listed companies, state-owned assets should be revalued. However, comparable market values are unobtainable for most of state-owned assets except for the purchase price. If fair value method is adopted, there exists room for accounting manipulation. Enterprises are afraid to be blamed for providing false accounting information. This led to a judgment that reliability must be put before the relevance in developing accounting standards.

#### **5.2.2.2 The Lack of Conservatism Accounting Convention**

Some researchers contend that the differences between the CAS and the IAS lay mainly in a lack of the “conservatism accounting convention” in Chinese accounting (Shun, 1996). For instance, Chen et al. (2002) and Chen et al. (1999) compared the

accounting information released by Chinese listed companies that had simultaneously issued A- and B shares. They conclude that a substantial overstatement of income or assets exists in those firms' financial reporting for A-share (prepared under Chinese accounting standards) in contrast with their financial statement for B-share reporting (prepared under the IAS). Those studies suggest the major causes underlying the discrepancies may come from the less conservative treatments of bad-debt allowances and depreciation, varied procedures to account for goodwill amortization, pension costs and other employee benefits, R&D spending, tax expenses, and a lack of provision for inventory price decline or value impairment of long term assets or investments (Shun, 1996; Chen et al., 1999).

Evaluation methods and the lack of prudence accounting convention are only two examples for the differences of accounting practices between the IAS and the CAS.

Interviewee B remarked:

The convergence of Chinese accounting standards to the IAS is inevitable due to the requirements from the development of the equity market. However, immature equity market, SOE restructuring and other inertial factors such as accounting tradition determines that the convergence could be a gradual and long process.

### **5.3 The Response of the Accounting System to the Problems of Financial Information Disclosure**

The efforts to improve the decision-usefulness of accounting information began in 1993 with the implementation of the new accounting system. As earlier mentioned, the efforts

could be summarized from two aspects: the issuance new standards to narrow the gaps of accounting practices between the CAS and the IAS, and the issuance of regulations and requirements for information disclosure (interviewee C).

### **5.3.1 Narrowing the Gaps of Accounting Practices between the CAS and the IAS**

There are three stages of accounting standards reform in China in 1993, 2000 and 2006 respectively. Each stage represents a big step in convergence towards the IAS.

#### **5.3.1.1 The First Stage 1993-1998: 1993 Accounting Standards for Business Enterprises**

With the rapid development of the securities market, business transactions became more and more complex. There was a call for a conceptual framework and detailed Accounting Standards (Xiang, 1998; Chen et al., 1999). The 1993 ASBE defined the basic accounting elements as follows: asset (Chapter 3), liability (Chapter 4), equity (Chapter 5), revenue (Chapter 6), expense (Chapter 7) and income or profit (Chapter 8). According to the Chinese 1993 set, then, the recognition, representation and reporting of these basic elements as a system produced the financial statements (Chapter 9), articulated around the balance sheet, the profit and loss statement (income statement), the statement of changes in financial position, the supplementary statements and notes and the statement of financial affairs.

These basic elements are common sense for Western accountants and accounting users, but were the first time formally introduced into Chinese accounting standards as standards that should be applied by all types of enterprise entities. The state-owned enterprises were being changed from 'production units' towards entities with more autonomy and operating responsibility. And the general purpose of the accounting system was to assist the financial practices of the enterprise to be accounted for on an accrual basis, away from central planning and management, previously accounted for on a cash basis (Aiken et al., 1995; p160).

The new objectives of the 1993 set were briefly summarized in Chapter 2 as follows: (1) to meet the needs of macro-economic management, (2) to allow relevant parties to assess the financial position and operating results of the business enterprises they are concerned with, and (3) to meet the information needs of business management (ASBE, 1993). Thus, the new system aimed to serve the re-shaped needs of governmental control and regulation, the emerging needs of new stakeholders in the autonomous entities that are in formation, and the new needs of responsible management at the enterprise level.

The introduction of ASBE was considered most significant as Interviewee B said:

It signaled the end of traditional accounting in China. For the first time in Chinese accounting history, the ASBE brought China's accounting practice into close conformity with the IAS. And before the conceptual

framework was released, accounting practice varied among enterprises with different types of ownership, different industrial sectors and different business purposes. For the first time, the ASBE provided a unified accounting framework to all Chinese business enterprises and they supersede all previously promulgated “accounting regulations”. In addition, the new accounting system initiated a transition from rule-based accounting regulations to transaction-based accounting standards in the regulatory framework of Chinese accounting.

#### **5.3.1.2 The Second Stage 1998-2005: 2000 Enterprise Accounting System**

A series of financial scandals of listed companies were exposed throughout the late 1990s. Extensive false reporting and earnings management by companies have discredited accounting information and hampered the development of the capital market.

In response to these financial scandals, the MoF issued *Accounting Regulations for Listed Companies* in 1998. The *Accounting Law* was amended in 1999 to stress the importance of ‘true and complete’ accounting information. In 2000, new accounting regulations were issued by the MoF, as interviewee C said:

A series of regulatory responses were needed in the case of serious accounting information crisis. These series of regulations and new standards aimed to reduce the scope for manipulation that can take



place under the looser definition provided in the ASBE. Therefore, they were expected to enhance the comparability of accounting information.

In 1999, *Enterprise Financial Reporting Regulation* issued by the State Council redefined the elements of financial statements in line with the IAS (Xiao et al., 2004). These definitions were further elaborated in the Enterprise Accounting System issued in 2000.

The Enterprise Accounting System defined basic concepts, elements of financial statements, recognition and measurement principles, permissible accounting methods, structures and content of the main financial statements (EAS, 2000). The revised accounting standards introduced important changes to existing practices. The changes also included reducing orientation towards the government, as government is no longer emphasized as the most important user group. This meant Chinese accounting system stressed more on the needs of outsider investors and were determined to further their efforts to provide more transparent and decision-useful accounting information (Xiao et al., 2004; Chen et al., 2002; Biondi and Zhang, 2007).

The most significant change in these new standards and regulations, as interviewee C said, was a more expanded application of the prudence principle than that was first prescribed in ASBE in 1993.

Conservatism in accounting standards was gradually stressed due to the impact from the Asian economic crisis and changes in the Chinese economy. In the 1998 Accounting Regulation for Listed Companies, the application of conservatism accounting conventions were typically reflected by requirements for enough provision for possible losses of short-term investments, receivables, inventory, and long-term investments. The regulations removed such ambiguous requirements as free management discretion to choose between cost and equity methods in accounting for long-term investment with share holding (Chen et al., 1999; Chen et al., 2002). Differences caused by allowance for bad debts, long-term investment valuation and deferred tax and other tax-related items were largely eliminated with the implementation of the new regulations. All these changes were expected to reduce about 40 percent of the total difference of reported earnings between the CAS and the IAS (Chen et al., 1999).

From the discussion above, the revised regulation significantly narrows the gap between the CAS and the IAS (accounting interviewee A).

#### **5.3.1.3 The Third Stage 2006- : 2006 new Accounting Standards for Business Enterprises**

The new 2006 ASBE included a revised conceptual framework (the basic statement) and 38 revised specific accounting standards. It did not simply expand the disclosure requirements but made fundamental changes to current CAS. It covered nearly all of the topics under the current IFRS literature. These standards were substantially in line with

IFRSs, except for certain modifications which reflect China's unique circumstances and environment (Deloitte, 2006).

The International Accounting Standards Board (IASB) identified a number of accounting issues for which China, because of its unique circumstances and environment, could be "particularly helpful to the IASB in finding high quality solutions for the IAS" (Liu, 2007). These issues include disclosure of related party transactions, business combinations involving enterprises under common control, and fair value measurements (Liu, 2007). The disclosure of related party transactions was in a process of improvement throughout the period of late 1990s to early 2000s. Application of the fair value measurements for the first time in the 2006 ASBE was a response to the IASB requirements (Interviewee C).

Although fair value was fully adopted in some areas, such as non-monetary transactions and marketable securities, in many cases where full adoption of fair value might be impractical or theoretically unsound, partial adoption were carried out. For example, investment property and biological assets may be measured at fair value if certain criteria are met, and the historical cost basis remains the benchmark approach (Biondi and Zhang, 2007). This is a big step for Chinese accounting standards to converge towards the IAS and the revision of accounting methods of business combination is under way (Xie and Tian, 2000).

### **5.3.2 Regulation and Requirements for Information Disclosure**

The Chinese accounting standards and the CSRC regulations are continuously improved in terms of information disclosure of listed companies, as interviewee B remarked:

The listed companies' information disclosure been promoted greatly compared with the situations in 1997 when the regulations for and supervision over information disclosure were embryonic: the content of information disclosure is now more detailed; the authenticity, the concept definitions are clearer; and the supervision is more efficient and independent.

#### **5.3.2.1 Regulations of Information Disclosure by the MoF**

From 1997 to 1998, eight specific accounting standards were formally promulgated by the MoF. They were: Disclosure of Related Party Relationships and Transactions, Cash Flow Statements, Events Occurring after the Balance Sheet Date, Debt Restructuring, Investments, Construction Contracts, Changes in Accounting Policies and Accounting Estimates, Revenue. Among these eight specific accounting standards, only Cash Flow Statements and Debt Restructuring are applicable to all enterprises while the remaining six are initially applicable to listed companies<sup>9</sup>. For a listed company, these standards ask for detailed useful and reliable information in its annual report. Thus, we can conclude that specific standards responded directly to the demand of the stock market (interviewee B).

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<sup>9</sup> Data source: the website of the MoF (<http://www.mof.gov.cn/>) (in Chinese).

For example, among these eight specific accounting standards, Disclosure of Related Party Relationships and Transactions was the first detailed accounting standard being issued to tackle the increasing acute earnings manipulation via related party transactions. Before its issuance, there was no requirement or standard for the disclosure of related party transactions (Zhong, 2005). This standard requires that when transactions are conducted between related parties, the nature, type and other pertinent information of the transaction should be disclosed in the financial statements. Factors to be disclosed include the amount involved or applicable %, outstanding balance and the basis to determine transfer prices. If ownership relationship exists, and if the related party is an enterprise, then regardless of whether transactions have been conducted between these parties, certain information (including primary operating scope, shareholding ratios and change in equity, etc.) should be clearly disclosed in the footnotes to the financial statements<sup>10</sup>.

In 2001, the MoF issued *Provisional Regulations on Accounting Treatments of Assets Sale Among Related Parties*, which required that all the obvious unfair transactions' price difference must not been recognized as profit of the current fiscal year. Together with the specific standard concerning related party transaction, detailed and explicit regulations were provided to regulate the disclosure of listed companies' related transactions in China in responses to the phenomena that more and more companies used related transactions to enhance their performance.

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<sup>10</sup> Data source: the website of the MoF (<http://www.mof.gov.cn/>) (in Chinese).

### 5.3.2.2 Requirements for Information Disclosure by the CSRC

The regulatory framework for financial reporting has just taken shape in China, as the government has paid increasing attention to regulating accounting and information disclosure for the equity market. It was framed fully based on the requirements for disclosure by the SEC (Zhang, 2007; Zhang and Li, 1998).

In order to regulate the content and form of the information disclosure of listed companies, in June 1993, the CSRC issued an exposure draft of *Standards of Contents and Formats of Information Disclosure by Public Issuing Companies* according to *Provisional Byelaw of Stock Issuance and Exchange* (CSRC, 1994). These regulations not only define the specific content and form of the financial reporting, but are also the guide to audit the financial reports of listed companies (CSRC, 1994). In 1997, the CSRC established the formal draft, and later revised it separately in 1998, 1999, 2001 and 2003 in response to continuing demands from the equity market, and has founded a basically mature framework now (SINA finance).

In Table 6, Contents and formats of Annual Report (part of Standards of Contents and Formats of Information Disclosure by Public Issuing companies) serve as an example to discuss the changes of Content and Formats of Information Disclosure from 1993 to 2003. The standards issued in 1993, 1998 and 2003 were compared.

**Table 6 the Transformation of Contents and formats of Annual Report**

<b>Contents</b>	<b>1993</b>	<b>1998</b>	<b>2003</b>
Company profile	✓	✓	✓
Financial and Operation Overviews	✓	✓	✓
Changes in Share Capital and Shareholdings		✓	✓
Shareholders' Meeting		✓	✓
Business Report	✓	✓	
Directors' Report	✓	✓	✓
Supervisors' Report			✓
Significant Events	✓	✓	✓
Financial reporting Documents Available for Inspection	✓ ✓	✓ ✓	✓ ✓
Corporate governance			✓
Directors, Supervisors, Senior Officers Employees			✓
Important Notice			✓

Data source: CSRC Public Statements (1993, 1998, 2003).

From Table 6, we can find out that the content of required information disclosure keeps expanding. The disclosure of important notice, the situation of directors, supervisors, management personnel, and employee and corporate governance are emphasized.

Other documents by the CSRC include *the Answers to the Information Disclosure Regulations of Public Issuing Companies* in 2001, *Preparing Rules of Information Disclosure by Public Issuing Companies* issued in 2002, and *Regulations on Information Disclosure of Listed Companies* in 2006. The series of regulations provide more explicit and detailed requirements for the information disclosure, as interviewee E said:

Now we may take much more time preparing the annual report than when the regulations for information disclosure were introduced in middle 1990s... The requirements keep changing and new regulations are continuously added to old ones. It is much harder to keep any inside information away from outsiders than before...

## **6. Findings**

From the analysis above, a number of implications can be given for the relationship between the equity market and accounting reform in China.

First, requirements for high-quality accounting information link the development of Chinese equity market and accounting reform together. With the development of equity market, government involvement in SOEs management has gradually reduced. Equity market has gradually turned the SOEs from production units under central planning to listed entities with managerial autonomy and self-responsibility. On the other hand, the equity-outside market is getting stronger and the interests of outside investors should be fully considered. What is put into priority in satisfying their needs is to provide transparent and decision-useful accounting information of the listed companies (Ball et



al., 2003). The requirements for high quality accounting information became the main motivation for the improvement of accounting reform in China. "There is no doubt that the history of the development of China's equity market and accounting system is a history of the improvement of the quality of accounting information" (interviewee B).

Second, the weak equity-outside market in China leads to several problems of the decision-usefulness of accounting information. The weak equity-outside market is characterized by a specific ownership structure, in which the majority of shares are non-tradable and the minority of shares is held by outside investors, and a weak corporate governance mechanism, which offers great incentives to controlling shareholder to transfer resources away from firms for the benefits of themselves by accounting manipulation (Liu and Lu, 2002). Moreover, the segmentation of equity market adds to these structural weaknesses which altogether results in unreliable and incomparable accounting information.

Third, the accounting reform engaged in improving the quality of accounting information by issuing standards to narrow down the differences of accounting practices between the CAS and the IAS and regulations for information disclosure. These efforts are gradually carried out through the past 18 years after the establishment of equity market. The implementation of three sets of basic accounting in 1993, 2000 and 2006 respectively aimed to converge towards the IAS and reduce the incomparability of accounting information across countries. The regulations for information disclosure issued by the MoF and the CSRC purported to guarantee a more reliable and transparent financial reporting.

Through the discussions and analysis, there is no doubt that the development of equity market greatly helps the accounting system transform from a rigid uniform and central-planned economy-based accounting system to an IAS-oriented system, through its requirements for the decision-usefulness of accounting information. China has reached an obvious improvement on the quality of indigenous accounting and reporting and also on the information disclosure in China's securities market through harmonization with the international conventions.

However, without a further reform of the ownership structure and corporate governance mechanism of the listed companies, the immature equity market will hinder the effectiveness of information disclosure, and in turn the application of the accounting standards and regulations. China needs to devote itself further into this process in the future. The country will have to continue its move toward implementing a sophisticated and transparent accounting system.

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## **7. Appendix**

### **List of Questions in Interview Instrument**

1. What was the background of the establishment of equity market in China?

2. Before the establishment of the equity market in 1990, how were the accounting practices in the SOEs? How was the political intervention influence their daily operation?
3. How are the requirements for accounting information from different interest groups, like the state, institutional or individual investors?
4. After these SOEs went into listing, how did the government intervention affect them? How does the government control decide the ownership structure of the listed companies and affect the accounting information disclosure? How the corporate governance of listed companies affect the disclosure of accounting information?
5. Why do the financial scandals occur frequently in the late 1990s? What are the main means to accounting manipulation? Could you give some examples of financial frauds in the listed companies?
6. What are the major differences between the IAS and the CAS? Why do these differences remain?
7. What is the role of 1992 ASBE in the process of accounting reform?

8. Compared with the 1992 ASBE, what are the major changes of the 2000 Enterprise Accounting System and 2006 ASBE to narrow the gap between the CAS and the IAS?
9. As a regulatory body for listed companies, which major steps has the CSRC taken to improve the accounting information disclosure?